NYSBA

SUMMER 2020 | Vol. 38 | No. 2

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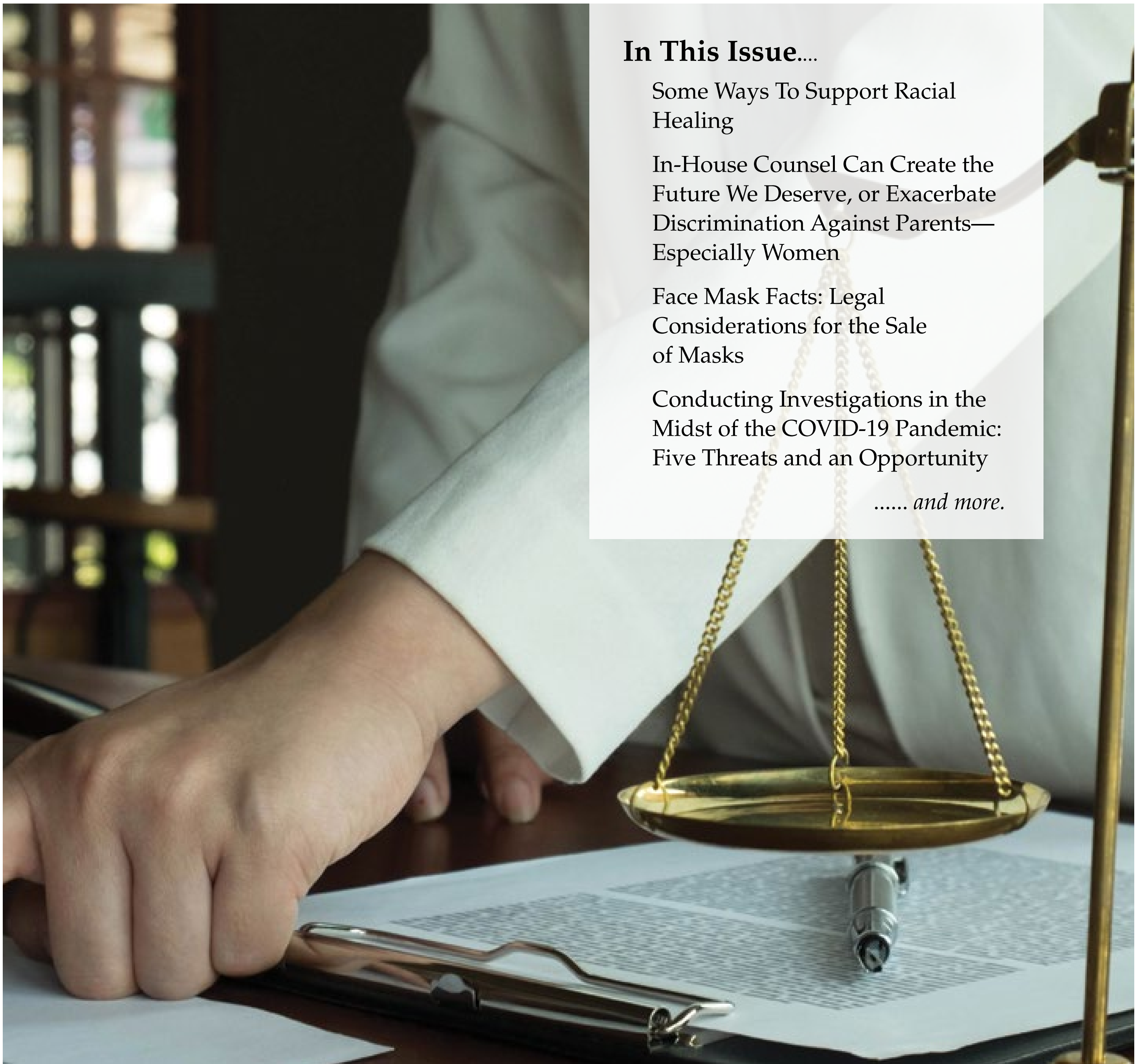
A publication of the Corporate Counsel Section
of the New York State Bar Association



In This Issue....

Strategies To Protect Your Company From Clawback Actions During These Turbulent Times and Beyond

By Leslie A. Berkoff

In-house counsel are frequently confronted with questions on how to handle delinquent accounts and how to work with customers/vendors/suppliers (collectively, "customers") who appear to be in financial distress. Counsel who have felt the impact of even one bankruptcy filing have become quickly familiar with the concept of a "preference" or "clawback" claim, which is the claim to recover money received from a customer within the 90 days prior to a bankruptcy filing. Unfortunately, these claims are the harsh reality of doing business with a financially troubled company. For those who practice in the restructuring space, it is an unpleasant conversation to have with a client; nothing is worse than explaining to a client who may already be out considerable dollars on account of unpaid obligations that they may now have to return money that they otherwise legally collected. Given the number of companies struggling to survive in light of the economic constraints created by COVID-19 and the anticipated influx of bankruptcy filings, now, more than ever, you should be considering proactive measures for managing delinquent accounts in an effort to avoid a clawback claim.

What Is a Preference?

As a starting proposition, it is important to understand what a preference is and when the claim arises. Section 547(b) of the Bankruptcy Code establishes, in salient part, that a preference is "a transfer of an interest of the debtor in property: (1) made to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the [bankruptcy] petition or within one year if the creditor is an insider [of the debtor]. . . ; (5) that enables such creditor to receive more than such creditor would receive… [in a chapter 7, liquidation]." 11 U.S.C. Section 547(b). In short, this means that anytime your company settles a claim, receives or accepts a payment of an outstanding obligation within the 90-day period preceding the filing of a debtor's bankruptcy petition (a.k.a., the "Preference Period"), or even does business with a financially distressed company, it may be subject to a preference claim brought by, or on behalf of, that debtor to recover a "preferential payment" that, under any other circumstance, your company is entitled to receive.

Of course, some financial relationships do not ordinarily give cause for concern. For example, if your company receives payment during the Preference Period on account of a fully or partially secured obligation and does not receive more in payment than the value of the collateral at that time, then there should be no valid basis to assert a preference claim with respect to that payment—this is because you have not received more than you would on liquidation and thus no prime facie preference claim could be established. More often than not, given that most companies' day-to-day customer relationships are unsecured in nature, these payments are fodder for a preference claim.

The possibility of having to return some or all of the payments received during the Preference Period, years after those payments were received, is difficult to comprehend, particularly when your company may have ended up never collecting all of the amounts due and owing.[1] However, there is a rationale behind the development of the construct known as a preference. This section of the Bankruptcy Code was actually enacted to promote fairness, its underpinning was to level the playing field to avoid a

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debtor "preferring" one creditor over another and paying them outside the ordinary course prior to filing. If your company did not receive any payment on account of obligations owed during the Preference Period, but a host of other companies received payments within the 90-day Preference Period, you would want some mechanism employed to equalize the financial impact of the debtor's bankruptcy filing. By allowing for preferential payments to be "clawed back" from those who were preferred, the clawed-back payments can be distributed to creditors on a *pro rata* basis, based on payment priority, so that all creditors receive the same "fair" treatment.[2] Unfortunately, the cost and time delay in recovering these funds does not always allow for a real return to creditors to be effectuated at times.

Can You Take Steps To Avoid Risk at the Outset?

While there are a variety of defenses to a preference action, some of which will be touched on below, it is preferable to implement measures that can help you avoid being subject to a preference claim from the outset—which means engaging in practices that minimize the risk of a prima facie claim being made. The most common mistake companies make is the automatic application of taking late incoming payments and applying them to the oldest invoice possible. In so doing, you have just facilitated a quintessential preferential transfer–payment on account of an antecedent debt. Instead, assuming the payor has not otherwise earmarked the payment for a specific older invoice,[3] you want to consider if there is a legitimate way to apply that payment to an invoice for a shipment of current goods or provision of services. You may be able to argue that the payment was not on account of an antecedent debt by making it a contemporaneous exchange of value. This is not foolproof, as a change in course of dealings can also raise a concern, but merely provides another argument to the mix.

Options for Application of Funds to Past Due Invoices

Alternatively, if you only have past due invoices, and the payment is not otherwise earmarked, you still have some options when considering how to apply that payment to open invoices, versus just automatically applying the payment to the oldest invoice. For this purpose it is important to understand your payment history with this customer so that you do not apply the payment in a manner that alters your ordinary course of business practice. Thus, if you received a payment and have various outstanding invoices–and can consider how best to apply it—the question becomes which invoice(s) should the payment be applied to in order to try to protect the same from avoidance down the road.

Let us explore this concept. While your company's standard invoice may have terms that say net 30 days, over time it is not uncommon for this arrangement to slip to net sixty days in practice such that while your stated business terms remain the same, your "ordinary course" relationship now differs from those terms. Assuming that there is a level of consistency to this change in practice you could take a later payment in and apply it to an older invoice consistent with that revised business practice and potentially have what is known as an "ordinary course" defense to a preference claim. While you have still received a preference, because payment is on account of a past due obligation, you would be able to argue that the historical relationship between the parties changed over time and this payment was made consistent with these practices.

Keep in mind that these claims often arise one to two years down the road after you have received the payment, after the company files for bankruptcy and once the bankruptcy case becomes ripe to pursue those claims. In order to establish an ordinary course of business defense, bankruptcy practitioners resort to preparing various forms of statistical analysis to provide snapshots of the payment relationship between the parties over varying time periods (usually to capture a schematic most closely aligned with the timing of any challenged payments). So as a general matter it is important to keep good records to support any changes or deviations in practice to allow you to rebut a challenge to your initial taking of a payment and buttress your ability to prove any of these defenses. Remember that defenses to a preference action are evidentiary in nature and you have the burden to prove the facts necessary to support your affirmative defense. Key information such as copies of invoices, due date of the same, date of delivery of goods or services as well as the type of payment and date it was received are all important.

Of course, the easiest way to avoid having to perform this analysis in the first place to ensure that the terms and conditions of a purchase order are clearly stated, understood, and complied with throughout the transaction, including the terms of credit and terms of payment by all parties concerned. This means if your business terms with the customer change, and a new billing practice is established, you should also change your invoices to match the terms at that time. For example, if the customer was originally required to pay you net 30 days of invoice, but you agree to allow the customer to pay net 60 days instead, you should modify the agreement and note the change on your invoices to the client. At the time the change in payment terms is made, you should also be sure to memorialize the new understanding in writing either by letter or email to the client (and be sure to save that writing in your records!). Allowing for slippage and ongoing deviations from these terms and conditions should be avoided as it allows for a trustee to argue that your receipt of a late payment during the preference period is outside the ordinary course, which undercuts your establishment of a new ordinary course relationship with the customer.

Don’t Make Dramatic Changes

Also upon learning that a customer is having financial troubles you should try to avoid making any sudden, unilateral changes in the timing of payments by the customer that could be construed as creating circumstances for a customer (soon to be bankrupt debtor) to prefer you over other creditors. For example, you should avoid dramatically constricting payments terms with the customer so that a historic net 30-day relationship is changed to a net five- or 10-day period. Courts can view these changes in the relationships and in payment structure as a deviation that justifies seeking recovery of a preference, so getting paid sooner all of a sudden is not good and may not be considered ordinary course between the parties.

Standardize Your Collection Practices

It is also important to standardize your collection practices. If your employees engage in threatening or harassing calls to “extort” payment to be made, an argument can be made that the payment(s) in question were in response to threats and that is why the debtor “preferred” your company. In fact, some courts will find that aggressive collection activities that result in payment undermine any ability to contend that it was an ordinary course payment. Note that prompt payment demands resulting in more expedited payments during the preference period may also be viewed as preferential and outside the ordinary course of business. Therefore, the more uniform your collection practices are for any past due obligation, the easier it will be to substantiate that the company did not deviate from the norm as concerns its dealings with the potential debtor.

To be clear, performing an extensive analysis of a customer’s payment history for day to day relationships with customers is not economically viable or realistic. The foregoing presumes that perhaps these are effectuated for large payments or significant obligations. So how do you deal with more mundane day-to-day payments (or even avoid issues on the bigger ones)? Change the timing of when you get paid completely to avoid having the payment be one that is made on “account of an antecedent debt.” So look to take cash before delivery or on delivery. This will allow you to argue that payment is due when the customer get the goods or before, so that the exchange is not on account of an antecedent debt. Even if one were to try to consider the exchange antecedent in nature, there is also an independent defense to a preference claim for a contemporaneous exchange for value that would apply.

How To Handle Settlement Payment

What about the question of settlement payments for pending or threatened disputes? Those are clearly being made on account of an antecedent debt. In fact any demand letter or claim you make for those obligations will certainly spell out that the obligations are past due. Unfortunately, you cannot simply build into the settlement agreement a waiver that the payment is not a preferential one, as that wavier would not be upheld in a bankruptcy court. Of course, you could put in language that says in the event that a compromised or reduced payment sum is later found to be a preferential transfer and unwound, you reserve the right to assert the full amount remains due and owing; this way you are not left with both a returned payment and a lower claim amount (of course in a case where unsecured creditors can get pennies on the dollar, that helps only just so much).

If your settlement includes a release of claims then there are some additional steps you can take. First, you also could incorporate into the settlement agreement that by providing the release, the company is getting new value in exchange for the settlement—in such instance I would have the agreement recite the consideration that is being given in exchange for the payment and that the release has value and the exchange is intended to be contemporaneous in nature. Depending upon the facts this might work to stave off a claim.

Second, you could also consider if the agreement includes releases for the primary obligor and potential third parties, not giving releases under the settlement agreement until 91 days after the last payment is received to try to avoid the preference claim. Other than when dealing with insiders of a company (insiders are generally family members or corporate affiliates or parties in control of corporate entities generally), the lookback for a preference is the 90 days prior to filing (for insiders it is a year). So if you are settling claims, and are going to give releases to other parties, perhaps hold these releases until the 91st day passes so that there is some incentive for the payor to hold off filing for bankruptcy.

Third, consider whether a third party can make the payment instead of the potential bankrupt entity and earmark them as payment for this obligation. The earmarking doctrine protects transfers that are made to the creditor by a non-debtor third party and, if properly structured, would avoid a preference claim. It should be noted that depending upon the facts, if the paying company subsequently files for bankruptcy, and no consideration is received by them in exchange for this payment, then this transfer could be considered to be a fraudulent conveyance against the creditors of their estate. One key practice pointer across the board is that no company can receive a payment from anyone who is not the obligor, so absent a structured agreement that provides a reasoned basis to do so, you will leave the realm and risk of preferences and end up in the area of fraudulent conveyances—which has a much longer lookback period. So in deciding to take a payment from a third party you need to run some risk analysis on this as well.

When All Else Fails

In the end it is important to remember that there is nothing wrong with accepting payment for an outstanding debt—it is not illegal or wrong; possession is indeed nine-tenths of the law, so better in your pocket than the debtor's pocket. The risk of a preference payment has become part of the cost of doing business. Not every distressed company files for bankruptcy and not every bankruptcy leads to demands for recovery of preference claims or fraudulent conveyances and thus there may never be a need to return the payment. Moreover, even if repayment is demanded, you may only need to return a portion of that payment. Of course hiring a good bankruptcy lawyer who can guide you in considering how to address doing business with a financially troubled company and/or responding to these demand letters is the first step to protecting money that you have received. Given that this question will not arise for some period of time if at all, when in doubt it is always better to accept the payment. Accepting the risk of a potential Preference Claim is part of the cost of doing business, but using some of the protective measures discussed in this article will help place you in the best position possible in the event a trustee does attempt to claw back the payment from you sometime down the road.

Endnotes

1. In most cases, the clawback actions are brought by the bankruptcy trustee (or debtor in possession) on or shortly before the two-year anniversary of the filing of the debtor's bankruptcy petition to avoid having their clawback claims barred by the two year statute of limitations.
2. It is important to note that there is no intent requirement at all for establishing a preference, so it does not matter whether the debtor intended preferred your company or not for a trustee to bring a preference action against you. In many cases, trustees simply bring preference claims against any creditor that received a payment during the Preference Period and will sort out the valid claims after the fact (and after your company is forced to retain an attorney to negotiate a resolution with the trustee). Recent changes to the Bankruptcy Code require a level of due diligence prior to commencing these claims.
3. If the payment is made and specifically delineates that it is on account of an invoice or series of invoices, you have to apply the payment to those invoices and any option on your part is removed.